

Rating Update: Moody's downgrades Howard University (DC) to Baa1; outlook negative

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\$290 M rated debt

DISTRICT OF COLUMBIA
Private Colleges & Universities
DC

Opinion

NEW YORK, September 24, 2013 --Moody's Investors Service has downgraded the District of Columbia Revenue Bonds (The Howard University Issue) Series 2011A and Series 2011B (Taxable) to Baa1 from A3, concluding the review that was initiated on July 8, 2013. The downgrade is driven by pressure on all of the university's major revenue sources. The negative outlook reflects an aggressive Fiscal Year 2014 budget that may prove difficult to implement in light of pressure on hospital operations, continuing soft enrollment, and a slow start to implementing planned efficiencies. It also reflects renewal risk associated with a revolving line of credit upon which the university relies for liquidity.

SUMMARY RATING RATIONALE

Howard University operates in a challenging operating environment. It is a private university, but is heavily supported by the US (Aaa stable) government. It owns and operates a hospital that serves as the safety net hospital for the university's immediate neighborhood in Washington, D.C., but does not receive direct local support. The hospital has been a drag on the university's financial condition and, in Fiscal Year (FY) 2013, the hospital experienced a sharp decline in admissions and a shortfall of \$17 million in revenue from hospital operations.

The downgrade of Howard University's rating to Baa1 reflects this loss of patient volume and revenue. It also reflects a marked drop in enrollment in Fall 2012 and cuts in direct appropriations from the federal government. At the same time, fundraising is weak. Operations for FY 2013 were only positive due to nonrecurring financial solutions that kept the university from posting an operating loss.

The negative outlook is predicated on continuing challenges. The university's FY 2014 budget, while balanced may be difficult to achieve as initiatives to lower payroll and other costs may prove increasingly difficult. At this time, the university has solicited proposals for another party to manage, joint venture, or buy the hospital. The outcome of this initiative could result in separation of the hospital from the university allowing the university to cut its losses, but the ability to find an appropriate partner and the willingness of the university to make difficult choices regarding its hospital and longstanding clinical care operation remain uncertain. In addition, the \$135 million multi-bank credit agreement upon which the university relies for liquidity is due to expire in June 2014.

The rating benefits from the university's solid reputation as a comprehensive, research-intensive Historically Black College & University with consistent and meaningful direct annual support from the US government. Other strengths include over \$0.5 billion in total cash and investments and fairly liquid investments translating to five months cash on hand in addition to the \$135 million working capital line. The university's operating cash-flow margin of approximately 10% in FY 2013 provided over three times estimated coverage of debt service.

CHALLENGES

*Hospital operations are a drag on university operations. The stand-alone academic medical center is largely dependent on Medicaid and market share eroded after the introduction of a new Medicaid managed care plan to the market last year. Revenues for FY 2013 were \$17 million short of budget.

*The university is dependent on various revenues from the federal government and those revenues are declining. Cuts to the university's direct federal appropriation due to first year of sequestration will impact the university mostly in FY 2014. Research grant awards are also declining which will impact direct as well as indirect cost recovery.

*Tightening lending criteria for federal Parent PLUS loans contributed to a 6.3% reduction in enrollment in Fall 2012. While many of the loan denials were successfully appealed and enrollment is expected to partially recover in Fall 2013, the university will suffer from lower total enrollment for at least three more years. To address affordability, Howard froze tuition for Fall 2013.

*Cash-flow is more difficult for Howard to manage than other universities due to the fact that timing of payments from the federal government can be unpredictable. The university intends to renew the \$135 million multi-bank credit agreement upon which the university relies for cash-flow before it expires on June 24, 2014.

*Corrective action may prove difficult to implement given transition of senior leadership, history of discord among board members, and other members of the Howard community that are not fully supportive of expense initiatives.

*Indirect debt including pension obligations and operating leases are significant. In addition, the university has agreed to reimbursement for certain operating expenses only after payment of debt service for two new privatized student housing facilities.

STRENGTHS

*The university has a strong and well-established reputation and is a leading black college in the US.

*The university benefits from almost one-quarter of one billion dollars annually in direct appropriations from the US government.

*Howard is relatively large with an estimated \$520 million in total cash and investments for FY 2013 and \$840 million of total revenues.

*Debt is relatively low with debt to revenue of 0.47 times and monthly liquidity covers demand debt by almost eight times.

*Total financial resources per student, monthly liquidity as a percentage of total cash and investments, and debt service coverage all compare favorably to other large private universities rated in the Baa category.

DETAILED CREDIT DISCUSSION

UPDATES

Howard University Hospital: The hospital has a remarkably weak profile owing to an older, inefficient facility, low and declining utilization and challenging payer mix. In spite of receiving over \$35 million annually in disproportionate share funding and over \$28 million annually in federal appropriations, the operating performance declined materially in FY 2013 from already weak levels in FY 2012. Deterioration reflects a weakening payer mix (over 82% of revenue derived from Medicare, Medicaid and self pay) and outsized volume declines (nearly 12% decline in inpatient admissions) that has resulted in market share loss. The hospital is almost 40 years old, suggesting that capital improvements are necessary to maintain service levels and restore competitive footing. In fact, management attributes some of the volume loss in FY 2013 to weak physician recruitment partially reflecting aged facilities. Management is aggressively addressing specific, measurable cost reduction initiatives and revenue growth plans for FY 2014, however, we view the hospital's current competitive and financial platform as inadequate to meet the challenges given the weak payer mix. Given these challenges, our outlook incorporates expectations of potentially sustained operating stress from the hospital.

The university has hired Raymond James & Associates to assist in identifying potential strategic partners to both "capitalize on the hospital's institutional strengths as part of a greater healthcare network and develop innovative delivery models to better serve the D.C. healthcare community". It is unclear, at this time, whether a suitable strategic partner can be found. If not, the university will be faced with having to decide whether to continue to subsidize hospital operations, significantly restructure operations at the hospital, or close the hospital. Any of these choices could involve financial risks and could potentially impact the university's educational model. Furthermore, university leadership may not be able to agree on a course of action which could result in further drain of resources.

Enrollment: The sudden drop in enrollment in Fall 2012 will have a multi-year impact on the university as the smaller class works its way through the university. In Fall 2012, after lending criteria for the federal Parent PLUS loan program tightened, there were 9,294 full-time equivalent (FTE) students down 6.3% from 9,917 students in the prior year. The university projects a slightly improved, but still depressed 9,516 FTEs for Fall 2013.

Operations: FY 2014 is expected to be a very difficult year for the university as reductions in direct federal appropriations, student loans, research grants, and Medicare are expected to reach \$25 million. The budget is designed to end with a fifth consecutive surplus from operations, but projected expense reduction may be difficult to achieve. The FY 2014 budget calls for a \$12 million reduction in employee benefits, a \$6 million reduction in professional and administrative services, and reduction in utilities and telecommunications expense. On the revenue side, the budget anticipates an \$8 million increase in net tuition as well as improved tuition collections, and a 10% investment return. Due to a delay in expense reduction, management estimates that the university is behind budget for the first three months of the fiscal year. In the event of additional federal funding reductions, FY 2015 could be even more difficult for the university.

FY 2013 is estimated to have ended with 1.0% Moody's-calculated operating margin and a 10% cash-flow margin covering debt service by a comfortable 2.79 times, as calculated by the university, compared to a 1.25 times debt service coverage covenant. Performance in FY 2013 is estimated to have been positive only because of several nonrecurring items. Federal sequestration reductions of \$9 million were deferred until the federal government's fourth quarter (July through September, 2013), a \$6 million employer contribution to the university's 403 (b) plan was temporarily suspended. The university also saved \$7.5 million when it converted its retiree healthcare program to commercial insurance and benefited from a solid investment return of 13%.

Balance Sheet and Liquidity: Financial resources are estimated to have grown to \$317 million after securing commercial insurance for retiree health care benefits and removing the post retirement health care (OPEB) liability from the university's balance sheet. Expendable financial resources to debt improved to 0.49 times, in line with other large private Baa-rated universities. Expendable financial resources to operations, however, are still weaker than peers at an estimated 0.23 times for FY 2013.

Access to working capital is particularly important to Howard as over one-quarter of its revenue comes directly from the federal government that sometimes makes partial payments to the university under continuing resolutions. The university's liquidity is satisfactory with \$329 million available within one month as of June 30, 2013. This liquidity translates into roughly five months of operating expenses. To bolster this position, the university maintains a multi-bank credit agreement for \$135 million, equivalent to an additional two months of expenses. In FY 2013, due to the unexpected drop in revenue, the university increased the net draw on its line by \$10 million compared to the prior year. The \$40 million balance as of June 30, 2013 has subsequently been paid off. The line expires on June 24, 2014 and the university has initiated a discussion about extending it. Failure to maintain a sizeable line of credit given the university's liquidity position and its dependence on sporadically paid federal appropriations, could result in a further downgrade.

Student Housing Project: The university is increasing its residential student housing by 30% to 5,826 beds with the addition of two facilities for freshmen and sophomores in what will now be an underclassman residential neighborhood. These new dorms will undoubtedly be attractive to incoming students and help with the university's student draw. Construction was financed (\$108 million bond issue) by a private developer, but the facilities will be built on university-owned land, the university will manage the dorms, and will market them along with other housing options. We expect the university to be paid from project revenue, for managing the facilities and to be reimbursed for the cost of utilities despite the fact that reimbursement of the utilities expense (approximately \$1.7 million, annually) is payable only after payment of debt service. Based on this assessment, we have not captured the debt associated with this project as debt of the university. However, in the future, if the university is not fully reimbursed for the utilities expense or if the university elects to provide financial or other significant support to the project, we could add some or all of the capital costs of the privatized project to direct debt of the university.

Governance and Management: The highly publicized discord among board members and deans earlier in 2013 appears to have quieted down. However, the aggressive cost-cutting outlined in the FY 2014 plan has slowed indicating that stakeholders may still not be aligned. This is particularly important as any delay in cutting costs will make it that much more difficult for the university to end the year without an operating loss.

The board is in the midst of a search to find a permanent CFO to replace the contracted CFO. In addition, the chairman and president are approaching the end of their commitments to the university. Any of this transition may prove distracting to the university's efforts to address its current challenges.

Legal Security: The revenue bonds are an unconditional general obligation of the university. There is a rate covenant of 1.1 times and an additional bonds test that requires a certificate of the university's chief financial officer concluding that projected debt service coverage will be at least 1.1 times upon issuance and, on a pro forma basis for the following fiscal year. In addition, there is a negative pledge on real estate and, for the Series 2011A bonds only, a one-half maximum annual debt service reserve fund.

Additionally, the university maintains a \$135 million operating line with a consortium of banks led by Bank of America, N.A. (A3/P-2 under review for possible upgrade). There are two financial covenants, a debt service coverage covenant of 1.25 times and a liquidity covenant of 35%. As of June 30, 2013, the university estimates that it exceeds these levels with 2.79 times debt service coverage and 62% liquidity. The agreement contains a "material adverse condition" clause that would permit the lenders to prohibit draws on the line if there were a material adverse change in, or a material adverse effect upon, the financial condition of the university or material impairment of the university's ability to perform its obligations under the loan documents. The agreement expires on June 24, 2014.

Debt Structure: Annual debt service, including that for bonds, capitalized leases and long-term notes is currently approximately \$31 million and declines slightly to \$25 million in 2042. Interest rates are primarily fixed.

OUTLOOK

The outlook is negative reflecting an aggressive budget for FY 2014 that may prove difficult to implement in light of pressure on hospital operations, continuing soft enrollment, potential further cuts to federal appropriations, and a slow start to implementing planned efficiencies. It also reflects renewal risk associated with a credit agreement that expires on June 24, 2014.

WHAT COULD CHANGE THE RATING UP

Given the negative outlook, an upgrade is unlikely. A change to stable outlook could result from resolution of hospital ownership and management as well as stabilization of enrollment and other sources of revenue that lead to improved operating cash flow as well as augmentation of financial resources consistent with large A-rated universities. Due to the unpredictable timing of receipts from the federal government and more volatile patient care exposure, Howard's liquidity will need to be higher than many comparably rated peers. Upward pressure would also be aided by a marked increase in philanthropic support.

WHAT COULD CHANGE THE RATING DOWN

A downgrade could result if the university is unsuccessful in right-sizing its operations to align with reduced revenues, a reduction of liquidity or financial resources. Leading indicators could include further declines in enrollment, inaction as it relates to the hospital, or a drawdown of reserves to support operations. Failure to renew the bank credit agreement, less headroom under the financial covenants, or the issuance of more debt could also result in a downgrade.

KEY INDICATORS (FY 2012 financial data, fall 2012 enrollment data; estimated FY 2013 data in parentheses)

Full-Time Equivalent Enrollment: 9,294 (9,516) students

Primary Selectivity: 49.3%

Primary Matriculation: 24.2%

Net Tuition per Student: \$14,814 (\$16,360)

Educational Expenses per Student: \$43,311 (\$42,454)

Average Gifts per Student \$730 (\$666)

Total Cash and Investments**: \$ 471 million (\$521 million)

Total Direct Debt: \$ 382 million (\$394 million)

Total Comprehensive Debt*: \$ 593 million (\$553 million)

Expendable Financial Resources to Direct Debt: -0.10 times (0.49 times)

Expendable Financial Resources to Operations: -0.04 times (0.23 times))

Monthly Days Cash on Hand: 136 days (154 days)

Operating Revenue: \$855.5 million (\$839 million)

Operating Cash Flow Margin: 10.4% (9.9%)

Three-Year Average Debt Service Coverage: 2.16 times (2.24 times)

Reliance on Patient Care Revenue (% of Moody's Adjusted Operating Revenue): 35.0% (32.8%)

* Comprehensive Debt includes direct debt, operating leases, and pension obligation.

** Does not include federal term funds.

RATED DEBT

Revenue Bonds, Series 2011A, Series 2011B: rated Baa1

METHODOLOGY

The principal methodology used in this rating was U.S. Not-for-Profit Private and Public Higher Education published in August 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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